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Japan's Economy Sends Mixed Signals

Japanese officials appear to be backing away from the government's target of 4 percent real growth in fiscal 1986 (April 1, 1986-March 31, 1987), which was based on an exchange rate of Y204=$1.00. Currently, the yen is trading around Y155=$1.00. In the long run, the increased purchasing power resulting from the strong yen and lower oil prices will benefit Japan's economy, but during FY 1986, the negative effect of lower export earnings will be dominant, slowing growth.

Business leaders fear that Japan may be headed for its first recession in more than three years. Gross national product contracted at a 2.1 percent annual rate during the first three months of 1986, the first negative quarter

since 1975. Last month's report by the Economic Planning Agency added to the pessimism, calling business conditions slack while avoiding the term "economic expansion" in referring to the economy.

The strong yen is reflected in the 0.9 percent drop in export volume in July, the fifth consecutive monthly decline. Based on the April-June quarter, the Waco Research Institute of Economics estimated that the pretax profits of Japan's 425 largest corporations (excluding banks, insurance companies, utilities and oil companies) will decline 29.4 percent in FY 1986. Smaller profits and slower growth have, in turn, made manufacturers bearish in their investment plans. Finance Minister Kiichi Miyazawa expressed concern last week that these trends will worsen employment conditions. Unemployment rose to 2.9 percent in July, matching the postwar record set in April. The jobless rate for men topped 3 percent for the first time, while employment in the manufacturing sector fell from year-earlier levels for the fifth consecutive month.

There are some bright spots in the economy, however. Consumer spending appears steady and housing starts rose 13.5 percent in July over the year-earlier period. Housing construction should remain strong during the rest of the year because of lower interest rates. As long as consumer spending and housing (which together account for 60 percent of GNP) hold firm, the economy will not fall into a recession.

According to EPA officials, real economic growth in fiscal 1986 will be about 2.8 percent, which would be the lowest rate since FY 1975. It is certain to fail to satisfy U.S. officials, who are hoping for more rapid Japanese growth to boost this country's exports. U.S. officials continue to pressure Tokyo for stimulative measures. At an unannounced September 6 meeting between Mr. Miyazawa and Treasury Secretary James Baker in San Francisco, Mr. Baker expressed doubt over Tokyo's commitment to meet the 4 percent target and urged Japan to act quickly to raise domestic demand.

The Japanese government has announced that a package of stimulative measures will be introduced September 19. The program is likely to include increased public works spending and promotion of housing construction; flexible monetary policy; deregulation of private business; measures to help small businesses hurt by the strong yen; and measures to pass on the windfall profits from the yen appreciation to consumers. Mr. Miyazawa said that no figure has been set for public works spending, which will be a major part of the supplementary budget to be submitted to the Diet this fall. Prime Minister Yasuhiro Nakasone said September 9 that the package will contain spending of Y3 trillion ($19.4 billion at Y155=$1.00).

Randall S. Jones

Ministries Announce Initial Budget Requests

Japan's initial round of budget negotiations was completed at the end of August when the twelve ministries and six independent agencies submitted their initial budget requests for fiscal 1987. The major features of the general account budget conformed to the cabinet's guidelines (see JEI Report No. 28B, August 1, 1986), although discretionary spending will rise only 0.5 percentage

point as opposed to the suggested 1 percentage point. Prime Minister Yasuhiro Nakasone has maintained fiscal austerity despite his appointment of the more expansion-minded Kiichi Miyazawa as finance minister.

The following table reveals the initial results of the budget negotiations. The largest gain is projected for debt service costs -- nearly a 25 percent increase. Almost one of every four yen of general account outlays will be earmarked for interest payments on the national debt in FY 1987, in contrast to one of every five this fiscal year. On a more encouraging note, aggregate official development assistance is scheduled to expand 7.5 percent as Tokyo continues to extend a bigger helping hand to developing nations.

Initial FY 1987 Budget Requests by Ministry

(in billions of yen)

	FY 1986	FY 1987	Percent Change
Justice	Y390.2	Y401.7	2.9%
Foreign Affairs	419.3	440.5	5.0
Finance	1,278.4	1,302.7	1.9
Education	4,572.2	4,578.8	0.1
Health and Welfare	9,772.1	10,190.9	4.3
Agriculture, Forestry and Fisheries	2,787.6	2,735.1	-1.9
International Trade and Industry	782.2	742.5	-5.1
Transportation	1,015.2	665.5	-34.4
Posts and Telecommunications	24.2	24.6	1.9
Labor	488.9	488.2	-0.1
Construction	3,774.0	3,693.0	-2.1
Home Affairs	106.4	76.4	-28.2
Imperial Palace	3.0	2.9	-1.4
Diet	83.7	83.7	-0.1
Judiciary	229.8	233.3	1.5
Audit Bureau	10.5	10.8	2.1
Cabinet	11.6	11.8	1.1
Prime Minister's Office	6,835.0	7,063.7	3.3
Total Discretionary Spending	32,584.2	32,746.0	0.5
of which Defense:	3,343.5	3,554.1	6.3
National Debt Payments	11,319.5	14,138.7	24.9
Transfers To Local Governments	10,185.0	10,815.6	6.2
Total General Account	54,088.6	57,700.3	6.7

Source: Ministry of Finance

The Ministry of Foreign Affairs is asking for Y316.9 billion ($2 billion at Y155=$1.00) in ODA, a 7.4 percent increase. Together with ODA requests from 14 other ministries totaling Y351.7 billion ($2.3 billion), Japan hopes to spend Y668.6 billion ($4.3 billion) from its general account budget on foreign aid. In addition, MOFA wants to set aside Y600-Y700 billion ($3.9-$4.5 billion) in yen loans for aid projects from the Fiscal Investment and Loan Program, Tokyo's second, self-financing budget. MOFA will seek to improve the quality of aid by selecting better development projects; shrinking the share of each project borne by the recipient country; restructuring existing projects that have experienced problems; and hiring consultants on foreign aid to evaluate its programs. MOFA was disappointed that FY 1985's ODA disbursements fell short of its goals and is seeking remedies to procedural bottlenecks (see JEI Report No. 24B, June 27, 1986). The stronger yen should also help MOFA meet its pledge to spend $40 billion in aid over the FY 1986-FY 1992 period.

At the Ministry of International Trade and Industry, officials have highlighted the agency's efforts to restructure the economy. The ministry wants to pump Y138.5 billion ($893.6 million) from its general account budget and Y29 billion ($187.1 million) from the FILP's industrial investment special account into programs to help small businesses deal with the yen's appreciation and restructure their operations to meet domestic demand. MITI wants another Y12 billion ($77.4 million) from the same special account to establish an "economic structure adjustment fund" aimed at helping local economies and small industries. Overseas direct investment promotion is to receive Y1.4 billion ($9 million). Domestic demand stimulation and regional economic development projects will consume Y100 million ($645,000), mostly for research and development centers, industrial parks and exhibition centers.

MITI's contribution to ODA will total Y21.6 billion ($139.4 million) and will be devoted to industrialization projects. As for science and technology promotion, the ministry is seeking Y50 million ($323,000) for its "human frontier" program, which seeks to develop bionics through large, joint international research projects. In addition, it will continue to fund numerous industrial technology programs, including development of the V2500 jet engine, the YXX passenger aircraft and the fifth-generation computer project.

There are signs of the "greying" of Japan, as the Health and Welfare Ministry's budget topped Y10 trillion ($64.5 billion) for the first time. Under its "policy for a long-life society," MHW will improve and double the number of day-care centers for senior citizens; strengthen research into the prevention and treatment of senile dementia and increase funding for biotechnology research. A record Y4 trillion ($25.8 billion) was requested for pension fund and medical care operations. MHW feels that more needs to be done, however. To supplement the estimated 1,100 welfare pension programs in Japan (representing 7.1 million participants and Y11.3 trillion ($2.9 billion) in assets as of March 31, 1986), MHW wants to establish an organization to help care for the elderly at an initial cost of Y3 billion ($19.4 million) -- with Y1 billion ($6.5 million) each coming from the general account, public pensions funds and private industry.

The Japan Defense Agency continued to hold its favored status with Mr. Nakasone's budget planners, garnering a 6.3 percent increase (slightly below the cabinet's 6.4 percent guideline). Air defense hardware forms the core of

JDA's Y1.7 trillion ($11 billion) weapons purchase plans; 16 F-15 interceptors, 12 P-3C anti-submarine planes and the Patriot surface-to-air missile system are listed, along with three destroyers. In addition, Y49 million ($316,000) will be spent on communications facilities to link air and sea forces with land bases via commercial satellites and Y6 million ($39,000) will be spent to study the construction of a very-long-range radar base in Japan.

It is important to remember that lengthy negotiations between Finance and other ministries have yet to take place before the final budget is compiled in December. Nevertheless, it is clear that while fiscal austerity rules overall expenditures, particular programs continue to receive special treatment.

Jon Choy

Japanese Defense Head Meets Administration Officials; Tokyo Approves SDI

Japan Defense Agency director general Yuko Kurihara met with top officials of the Reagan administration in Washington last week, assuring them that Japan would make every effort to meet its defense obligations. U.S. officials, in return, urged an increase in Tokyo's defense spending to offset increasing pressures in Washington that could affect both trade and defense relations.

Mr. Kurihara's visit was his first to Washington after resuming the defense post in the Nakasone government, which has been assured of another year in existence (see article in this issue). Japanese officials briefing the press said that Secretary of Defense Caspar Weinberger had told Mr. Kurihara that Congress is taking an increasingly isolationist posture, necessitating a larger Japanese defense role. Mr. Kurihara responded that Japan is in the process of fulfilling its five-year defense plan through an anticipated 6 percent spending hike for fiscal 1987.

Discussions also touched on less dramatic but equally important issues for the two allies, including Tokyo's decision to press ahead on construction of a controversial landing strip on Miyake Island for U.S. night landing exercises and U.S. requests for expanded payments for support of American forces in Japan.

On Mr. Kurihara's return to Japan, the Nakasone government formally announced its decision to allow participation in the Strategic Defense Initiative research program, although there are lingering concerns over repatriation of technology generated under SDI contracts by Japanese firms. Tokyo will now begin the long process of finalizing the terms of Japanese participation in the program.

In the meantime, officials have completed arrangements for transfers of dual-use technologies from Japan to the United States under notes exchanged in November 1983. The technologies, which involve missile image-seeking technology and ship design and production techniques, will be the first completed under the notes in what Washington hopes will be a significant flow in the future. Tokyo and Washington agreed to the transactions in principle in December 1985.

Michael W. Chinworth